

Asia's Domestic Demand Puzzle



Is Asian growth becoming more domestic demand led?

- Domestic demand is increasing across Asia but the region is still heavily reliant on exports for its growth
- Exchange rate management is the region's key policy management tool but there are structural impediments to faster re-balancing too
- China and India are the natural focus for investors because of their big domestic markets, however the whole region will be tested if the global economy faces a 'double-dip' recession

For many years a lively if inconclusive debate has continued over Asia's dependence on exports. The lightning rod for this is China's huge trade surpluses, supported by a 'cheap' currency. Last week Beijing moved to loosen its peg. The move was timely, coming just ahead of the G20 meeting.

China is not expected to revalue by more than 5% this year (see Fig 1), even though by common consent the renminbi is hugely undervalued on purchasing power parity basis (as are many of Asia's other currencies). But eventually the move could open the door to more domestic-led growth. As its foreign reserves grow, rising wealth will be recycled into more spending at home, making China more self-reliant.

To its critics, China's resistance to a renminbi rise is evidence of protectionism and a reluctance to let such 'decoupling' take its course. A stronger currency would make imports cheaper and act as a spur to consumption. Cost pressures might be alleviated too.

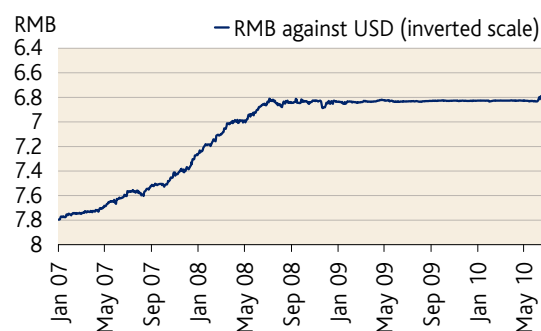
But there is a downside too, for both China and the US, its main trade partner. A stronger currency would see the trade surplus fall, leaving open the possibility that Chinese buying of US Treasuries would also fall (though the need to sterilise capital inflows could negate that). US borrowing costs would then rise, hurting not just US consumption but the economy at large. The value of existing Chinese Treasury holdings would also fall.

The role of the US dollar as the default global currency is critical to this co-dependence and arguably the least examined part. The US prints dollars freely knowing its trade partners will accept them, but such debasement complicates the very re-balancing it calls for. Still, both sides play down discomfort: the US that its largest creditor is China; Beijing that it is over-reliant on US consumer growth.

If the global economy may now be turning sluggish once again, US spending could be threatened. How will China (and the rest of Asia) then act?

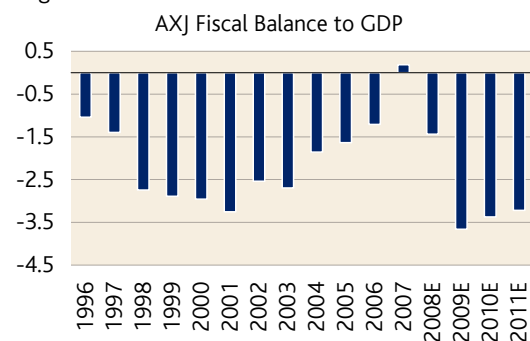
Their resolve is already being tested: Asia's recovery has been relatively swift thanks to fiscal spending backed by solid finances (Fig 2), and there is pressure now to normalise monetary policy (Fig 3). Fixed or tightly controlled exchange rates mean the region is importing the Fed's loose money, making nascent asset bubbles worse. In public Asia's central bankers cite an influx of 'hot money' as reason for their caution so far; but as yet there are few signs of a Plan 'B' if demand from the West fails to materialise and rescue Asia's export sector.

Fig 1



Source: Bloomberg, 28 Jun 10

Fig 2



Source: Morgan Stanley Research; E = Morgan Stanley Research Estimates, 25 Mar 10

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Not blinking first on policy is only the half of it. Asia's reluctance to stimulate demand at home is also structural. For exports are essential in order to pay for imports. Wealth is not yet at Western levels, so more needs to be shipped out.

The foundation stone of cheap and plentiful labour also points to challenges: millions still live at subsistence levels; job security is low and access to credit and markets is limited. Welfare and financial systems are primitive; poor tax collection inhibits redistribution and so precautionary savings rates are excessive. Getting people to spend more means overcoming these various rigidities.

So is Asia dragging its feet on the solutions such as market liberalisation, infrastructure development, education and skills, etc? Or merely being pragmatic about its shortcomings?

A glance at China suggests its institutions are weak and will take time to build, the financial system being symptomatic. It doesn't price capital properly, interest rates are artificially low and bad loans a potential cancer for its banks. Yet these weaknesses are the products of deliberate choices, albeit ones that do enable flexibility elsewhere. For example, China's dirigisme does mean state-directed lending is quickly put to work.

By contrast capitalist India's banks are generally well-run. So are their peers in Singapore or Hong Kong. Next to those in the West they look like paragons, having steered clear of securitisation. But India's infrastructure is poor (unlike China's), the result of years of under-investment and ambivalence over private sector involvement. That is changing, but goods still don't get to market and foodstuffs spoil in warehouses.

In short summary, the anecdotal evidence is that away from exchange rates, where real or de facto pegs are the norm, governments in the region often have their own development priorities. Domestic demand is promoted by proxy (such as through housing or lending programmes) or through ephemeral budget incentives; it isn't a policy end in itself.

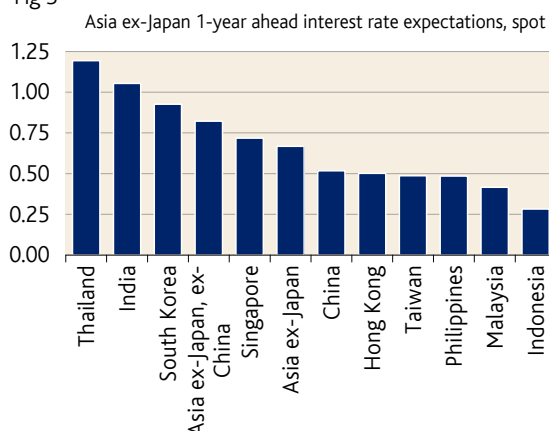
With this in mind, what is the evidence that growth in domestic demand is taking place? And does everyone define it in the same way?

Domestic demand is aggregate spending in an economy net of exports, and should properly include investment as well as public and private consumption. But it is private consumption that has the most room to grow. In the US consumption is about 65% of GDP; in China it is nearer 20%. In China investment is a significantly higher proportion of GDP, which is natural given its stage of development.

Making sense of the shifting factors of demand is not always easy. The trend data show that while regional private consumption as a percentage of exports is on the up (Fig 4), in broader GDP terms it seems to be falling in Asean and in N. Asia (Fig 5). That is not a promising sign. But the fall could reflect faster growth in investment in the shape of fixed capital formation – and not necessarily faster export growth from those countries.

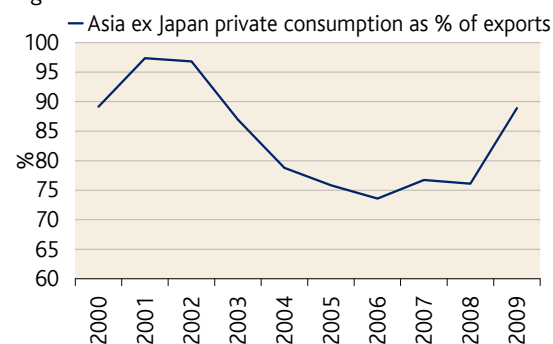
By contrast, the share of private consumption in India and China is on the rise, which is impressive, because we know investment has been strong, and investment usually leads spending.

Fig 3



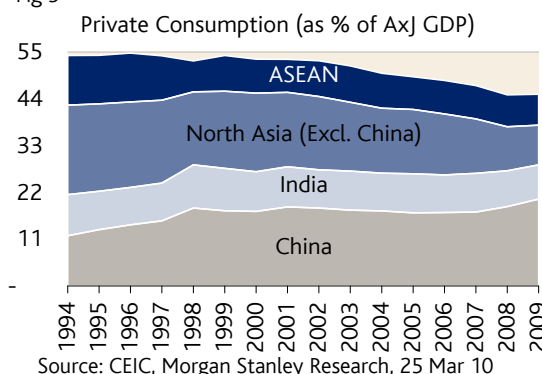
Source: BNP Paribas, Bloomberg, Reuters EcoWin Pro, 28 Jun 10

Fig 4



Source: Morgan Stanley Research; E = Morgan Stanley Research Estimates, 25 Mar 10

Fig 5



Source: CEIC, Morgan Stanley Research, 25 Mar 10

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We should pay attention to these two economies with Continental-sized domestic markets as they have the size to sustain re-balancing. Urbanisation is leading to more Western patterns of behaviour and spending. Usage rates for mobile phones, durable goods and autos are rising fast. This is the reason many multinationals are beating a path to China in particular – and leaving other countries to one side. In time the domestic market will complement and perhaps supplant exports.

China is already the world's largest car market, for example (Fig 6). Only a fraction of that production is sold abroad. Apart from planes, high tech toys and commodities, the daunting truth is that there will soon be few things China will want from the rest of the world that it can't make or source itself.

From an investor's perspective the natural interest is in whether all this growth is producing profits. To judge from all the FDI and portfolio flows (Fig 7), many will invest blind and defer an answer until later – which shows a touching faith. Yet despite the occasional waste or inefficiency (China's new-build ghost towns...) empirically Asia is producing more stuff for itself.

At some point, this has to lead to better balanced more self-reliant economies, as we have noted. But this transition is a process; it doesn't have a fixed end. That more could be done is incontestable. Whether countries are doing enough provokes larger questions about national self-interest. Measures of success or failure are opaque when countries enact similar policies (because there are a lack of examples by which to measure opportunity costs).

Be that as it may, in the face of economic decoupling – however slow motion – stock markets remain stubbornly *coupled* with respect to Western markets. In fact correlation has been increasing (Fig 8). If stock markets are a discounting mechanism, we must ask when those signals might change course.

Fig 6
China Monthly Passenger Vehicle Sales Volume Trend

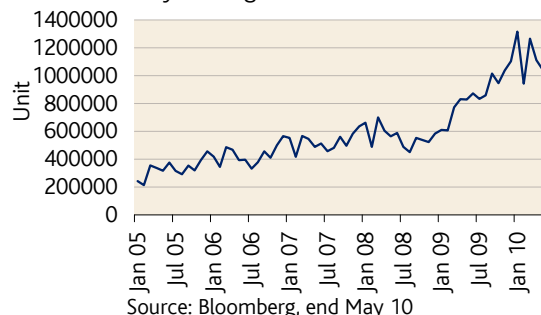


Fig 7
Net inflows of foreign direct investment

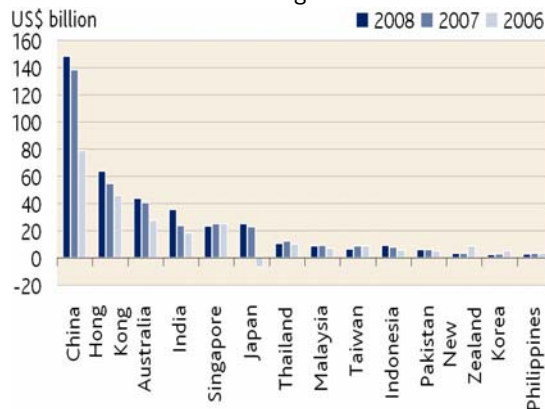
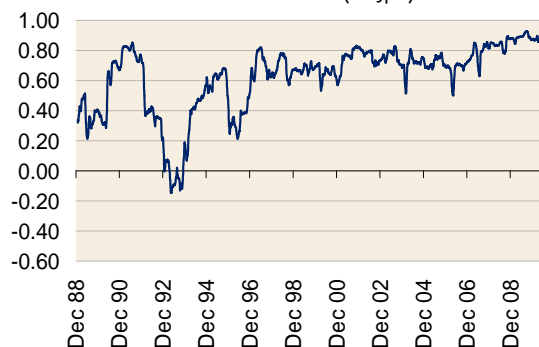


Fig 8
Correlation* between Asia (ex Jpn) and the US



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For more information

Client Services Team

Tel: +65 6395 2701

Fax: +65 6438 0743

Aberdeen Asset Management Asia Limited

21 Church Street

#01-01 Capital Square Two

Singapore 049480

Tel: +65 6395 2700

Fax: +65 6535 7159

www.aberdeen-asia.com

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